Konajaya Sdn Bhd v Perbadanan Urus Air Selangor Bhd

HIGH COURT (KUALA LUMPUR) — ORIGINATING SUMMONS NO D5–24–164 OF 2003
RAMLY ALI J
4 FEBRUARY 2009

Banking — Performance bonds — Call on bond — Classifications of — Manner of construction or interpretation — Whether bond conditional upon proof of breach or damage — Whether bank's intention and understanding of performance guarantee relevant to interpretation of such guarantee

Contract — Guarantee — Call on performance bond — Performance bond — Guarantee requiring defendant making call on bond to inform bank the basis of such call — Failure to state such basis, effect of

Contract — Guarantee — Performance bond — Classifications of — Manner of construction or interpretation — Whether bond conditional upon proof of breach or damage — Whether bank's intention and understanding of performance guarantee relevant to interpretation of such guarantee

The plaintiff and the defendant entered into a contract for the defendant to carry out certain design and construction works ('the works'). The plaintiff completed the works on 22 February 1999. Pursuant to the contract, the plaintiff provided the defendant with a guarantee issued by Maybank Bhd ('MBB') for the design of the works ('the guarantee'). The guarantee was to remain in force for 5 years and 6 months from the date of completion of the works on 22 February 1999. Thus the guarantee was to expire on 22 August 2004. On 30 June 2003, the plaintiff was notified by MBB that the defendant had made a call on the guarantee. The defendant had not given the plaintiff any prior notice of any claim on the guarantee. The plaintiff applied for and obtained an ex parte injunction, subsequently made inter partes, restraining the defendant from demanding and accepting any moneys under the guarantee pending the plaintiff's application for a declaration that the defendant had no right to call on the guarantee. The defendant failed to make any attempt to preserve the guarantee and it expired, pending hearing of the plaintiff's application on 22 August 2004. In support of its application, the plaintiff submitted: (a) the guarantee required the defendant to state the defects or damage to the works when making a demand to MBB; (b) the

defendant had failed to do so in its demand; and consequently (c) the defendant's demand to MBB for payment under the guarantee was invalid and ineffective. The defendant however countered, inter alia, that the guarantee was a performance bond which did not require anything more that a demand in writing to call on the guarantee. The High Court had thus to construe the guarantee in order to determine whether the defendant had failed to comply with its terms when making its demand for payment.

Held, allowing the plaintiff's application with costs:

(1) The bank guarantee was a performance bond, which is traditionally classified either as a conditional bond or an unconditional or on-demand bond. Notwithstanding this traditional classification, the courts have preferred a straightforward exercise of construction or interpretation of the bond to discover the intention of the parties (see paras 13–14); *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and another appeal* [1996] 2 MLJ 517 (FC) (followed) and *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149; distinguished.

(2) In the interpretation of performance bonds, the following three different constructions, based on the words used in such bonds, are possible: (i) no more than a mere written demand is required; (ii) the demand must assert a failure to perform the contract; and (iii) due to the use of the word 'damages', proof thereof and not mere assertion before liability arises (see paras 16–17); *Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor* [1985] Lloyds' Rep 546 (CA); *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and another appeal* [1996] 2 MLJ 517 (FC) and *Kerajaan Malaysia v South East Asia Insurance Bhd* [2000] 5 MLJ 265 followed.

(3) The words of some performance bonds may make the bond conditional upon proof or inquiry of the breach of the terms of the contract by the principal. In the instant case, the words of the bank guarantee did not make it conditional upon proof or inquiry of a breach of the contract by the plaintiff (see paras 19–20); *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149 distinguished.

(4) The words of certain performance bonds do not require anything more than a mere written demand to call on the performance bond. However, in the instant case, the bank guarantee required the defendant in its written demand to inform the bank that its demand was on the basis provided for in the guarantee itself. This straightforward interpretation in no way imposed any extravagant demand upon the bank. The bank

was not required to inquire or make any evaluation on the merits of the demand. It was not an unreasonable condition to impose on the defendant as all that was required was the defendant's bare statement without proof of the basis for its demand on the guarantee. This straightforward interpretation was consistent with the words in the preamble of the guarantee and also consistent with the words under cl 2.2.1 of the contract. Further, this interpretation was consistent with the actions of MBB in informing the plaintiff of the defendant's claim on the guarantee. The bank's intention and understanding of the guarantee was very relevant to its proper interpretation (see paras 21, 22, 23, 26 & 27).

(5) In the instant case, it was necessary for the defendant to claim some 'defect or damage' in the works to prevent any possible abuse of the guarantee. The plaintiff was also entitled, as a matter of natural justice, to know the reason why the defendant was calling on the bank guarantee (see para 30).

(6) The words 'without proof or conditions' in the guarantee did not mean 'without having to assign any reason whatsoever'. The words simply meant that the defendant was not required to prove an actual default by the plaintiff in the performance of the contract. However, even if proof of an actual default was not required, the defendant had to state in its written demand the basis upon which the demand was made. The words 'without proof or conditions' meant that upon receipt of a valid demand, the bank ought to pay the defendant the sum of the guarantee without imposing any conditions. In this case, however, the defendant's written demand was invalid for failing to state the basis for its demand (see paras 31–32); *Kirames Sdn Bhd v Federal Land Development Authority* [1991] 2 MLJ 198 distinguished; *Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor* [1985] Lloyds' Rep 546 (CA) referred.

(7) The words 'notwithstanding any contestation or protest by the contractor' in the guarantee were consistent with the interpretation/construction that the defendant had to state the basis upon which its demand was made (see para 33); *Teknik Cekap Sdn Bhd v Public Bank Bhd* [1995] 3 MLJ 449 and *Cygal Bhd v Bandar Subang Sdn Bhd* [2004] 3 CLJ 67; [1998] 1 LNS 414 referred.

(8) It was clear from the defendant's written demand that the defendant had failed and omitted to state any damage or defect to the works, or any breach of the plaintiff's obligation under the contract. This omission was fatal and rendered the defendant's written demand invalid and ineffective because it did not comply with the condition of the

bank guarantee as interpreted by the Federal Court. Thus, the defendant was not entitled to any payment under the bank guarantee (see para 36).

(9) In the instant case, the defendant's action showed a lack of good faith because the defendant had called on the guarantee without giving any notice to the plaintiff or without complaining of any defect or damage. It was a matter of natural justice that the plaintiff be informed by the defendant of its demand and what exactly the plaintiff was allegedly in breach of (see paras 55–56).

[Bahasa Malaysia summary

Plaintif dan defendan telah memasuki kontrak untuk defendan menjalankan kerja-kerja rekaan dan binaan tertentu ('kerja-kerja tersebut'). Plaintif telah menyiapkan kerja-kerja tersebut pada 22 Februari 1999. Menurut kontrak, plaintif telah memberikan defendan jaminan yang dikeluarkan oleh Maybank Bhd ('MBB') untuk rekaan kerja-kerja tersebut ('jaminan tersebut'). Jaminan itu sepatutnya berkuat kuasa selama 5 tahun dan 6 bulan daripada tarikh kerja-kerja disiapkan pada 22 Februari 1999. Oleh itu jaminan tersebut akan luput pada 22 Ogos 2004. Pada 30 Jun 2003, plaintif dimaklumkan oleh MBB bahawa defendan telah menuntut jaminan tersebut. Defendan tidak memberikan plaintif sebarang notis awal tentang apa-apa tuntutan atas jaminan tersebut. Plaintif telah memohon untuk dan memperoleh injunksi ex parte, yang kemudiannya menjadi inter partes, menghalang defendan daripada menuntut dan menerima apa-apa wang di bawah jaminan tersebut sementara permohonan plaintif untuk deklarasi bahawa defendan tiada hak untuk menuntut jaminan tersebut. Defendan gagal membuat apa-apa percubaan untuk mengekalkan jaminan tersebut dan ia telah luput, sementara menunggu perbicaraan permohonan plaintif pada 22 Ogos 2004. Bagi menyokong permohonannya, plaintif menghujahkan: (a) jaminan tersebut menghendaki defendan menyatakan kecacatan atau kerosakan kerja-kerja tersebut semasa membuat tuntutan kepada MBB; (b) defendan telah gagal berbuat sedemikian dalam tuntutannya; dan seterusnya (c) tuntutan defendan kepada MBB untuk bayaran di bawah jaminan tersebut adalah tidak sah dan tidak berkuat kuasa. Defendan walau bagaimanapun membantah, antara lain, bahawa jaminan tersebut merupakan bon pelaksanaan yang tidak menghendaki apa-apa selain tuntutan bertulis untuk menuntut jaminan tersebut. Mahkamah Tinggi oleh itu telah mentafsirkan jaminan tersebut bagi tujuan menentukan sama ada defendan telah gagal mematuhi terma-termanya semasa membuat tuntutannya untuk bayaran.

Diputuskan, membenarkan permohonan plaintif dengan kos:

(1) Jaminan bank adalah bon pelaksanaan, yang secara tradisi

diklasifikasikan sama ada sebagai bon bersyarat atau bon tidak bersyarat atau bon atas permintaan. Meskipun terdapat klasifikasi tradisional ini, mahkamah lebih suka menggunakan pembentukan atau pentafsiran mudah untuk bon itu bagi mengetahui niat pihak-pihak (lihat perenggan 13–14); *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and another appeal* [1996] 2 MLJ 517 (MP) (diikut) dan *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149 dibeza

(2) Dalam pentafsiran bon-bon pelaksanaan, tiga pentafsiran berikut, berdasarkan perkataan-perkataan yang digunakan dalam bon-bon sedemikian, adalah mungkin: (i) tidak lebih daripada hanya tuntutan bertulis diperlukan; (ii) tuntutan hendaklah menyatakan kegagalan untuk melaksanakan kontrak; dan (iii) disebabkan penggunaan perkataan 'damages', perlu ada bukti dan bukan hanya pengataan sebelum timbul liabiliti (lihat perenggan 16–17); *Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor* [1985] Lloyds' Rep 546 (MR); *China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and another appeal* [1996] 2 MLJ 517 (MP) dan *Kerajaan Malaysia v South East Asia Insurance Bhd* [2000] 5 MLJ 265 diikut.

(3) Terma di dalam beberapa bon pelaksanaan boleh menjadikan bon itu bersyarat berdasarkan bukti atau siasatan pelanggaran terma-terma kontrak oleh prinsipal. Dalam kes ini, perkataan-perkataan jaminan bank tidak menjadikannya bersyarat berdasarkan bukti atau siasatan pelanggaran kontrak oleh plaintif (lihat perenggan 19–20); *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149 dibeza.

(4) Terma-terma bon-bon pelaksanaan tertentu tidak memerlukan apa-apa selain tuntutan bertulis untuk menuntut bon pelaksanaan itu. Walau bagaimanapun, dalam kes ini, jaminan bank menghendaki defendan dalam tuntutan bertulisnya memaklumkan bank bahawa tuntutannya berasaskan apa yang diperuntukkan dalam jaminan itu sendiri. Pentafsiran yang jelas dan mudah ini adalah konsisten dengan perkataan-perkataan di kepala tajuk jaminan dan juga konsisten dengan perkataan-perkataan di bawah fasal 2.2.1 kontrak. Tambahan pula, pentafsiran ini adalah konsisten dengan tindakan-tindakan MBB yang memaklumkan plaintif tentang tuntutan defendan atas jaminan itu. Niat bank dan pemahaman jaminan amat relevan untuk pentafsiran sewajarnya (lihat perenggan 21, 22, 23, 26 & 27).

(5) Dalam kes ini, adalah perlu untuk defendan menuntut beberapa 'defect or damage' dalam kerja-kerja tersebut bagi menghalang sebarang kemungkinan penyalahgunaan jaminan itu. Plaintif juga berhak,

berdasarkan keadilan semulajadi, untuk mengetahui sebab kenapa defendan menuntut jaminan bank itu (lihat perenggan 30).

(6) Perkataan-perkataan 'without proof or conditions' dalam jaminan itu tidak bermaksud 'without having to assign any reason whatsoever'. Perkataan-perkataan itu hanya bermaksud bahawa defendan tidak dikehendaki membuktikan kegagalan sebenar oleh plaintif dalam pelaksanaan kontrak. Walau bagaimanapun, meskipun bukti kegagalan sebenar tidak diperlukan, defendan hendaklah menyatakan dalam tuntutan bertulisnya asas tuntutan itu dibuat. Perkataan-perkataan 'without proof or conditions' bermaksud setelah penerimaan tuntutan yang sah, bank patut membayar defendan jumlah jaminan itu tanpa mengenakan apa-apa syarat. Dalam kes ini, bagaimanapun, tuntutan bertulis defendan adalah tidak sah kerana gagal menyatakan asas tuntutannya (lihat perenggan 31–32); *Kirames Sdn Bhd v Federal Land Development Authority* [1991] 2 MLJ 198 dibeza; *Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor* [1985] Lloyds' Rep 546 (MR) dirujuk.

(7) Perkataan-perkataan 'notwithstanding any contestation or protest by the contractor' dalam jaminan itu adalah konsisten dengan pentafsiran bahawa defendan telah menyatakan asas di mana tuntutannya dibuat (lihat perenggan 33); *Teknik Cekap Sdn Bhd v Public Bank Bhd* [1995] 3 MLJ 449 dan *Cygal Bhd v Bandar Subang Sdn Bhd* [2004] 3 CLJ 67; [1998] 1 LNS 414 dirujuk.

(8) Adalah jelas daripada tuntutan bertulis defendan bahawa defendan telah gagal dan tertinggal untuk menyatakan apa-apa kerosakan atau kecacatan kerja-kerja tersebut, atau apa-apa pelanggaran tanggungjawab plaintif di bawah kontrak. Peninggalan ini adalah memudaratkan dan menyebabkan tuntutan bertulis defendan tidak sah dan tidak berkuat kuasa kerana ia tidak mematuhi syarat jaminan bank seperti yang ditafsirkan oleh Mahkamah Persekutuan. Oleh itu, defendan tidak berhak mendapat apa-apa bayaran di bawah jaminan bank itu (lihat perenggan 36).

(9) Dalam kes ini, tindakan defendan menunjukkan kekurangan niat baik kerana defendan telah menuntut jaminan itu tanpa memberikan sebarang notis kepada plaintif atau tanpa mengadu tentang sebarang kecacatan atau kerosakan. Ianya perkara berhubung keadilan semulajadi untuk plaintif dimaklumkan oleh defendan tentang tuntutannya dan apa sebenarnya yang dikatakan telah dilanggar oleh plaintif (lihat perenggan 55 & 56).]

Notes

For a case on call on bond, see 1 *Mallal's Digest* (4th Ed, 2006 Reissue) para 2092.

For a case on call on performance bond, see 3(1) *Mallal's Digest* (4th Ed, 2006 Reissue) para 3823.

For cases on performance bond, see 3(1) *Mallal's Digest* (4th Ed, 2006 Reissue) paras 4017–4034.

Cases referred to

China Airlines Ltd v Maltran Air Corp Sdn Bhd (formerly known as Maltran Air Services Corp Sdn Bhd) and another appeal [1996] 2 MLJ 517; [1996] 3 CLJ 163, FC (folld)

Cygal Bhd v Bandar Subang Sdn Bhd [2004] 3 CLJ 67 (CA); [1998] 1 LNS 414 (unreported) HC (refd)

Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor [1985] 2 Lloyds' Rep 546, CA (folld)

Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd [1995] 1 MLJ 149; [1995] 1 CLJ 283, SC (distd)

HSH Engineering & Construction Sdn Bhd v Belton Properties Sdn Bhd [2001] MLJU 85; [2001] 2 CLJ 186, HC (refd)

Kirames Sdn Bhd v Federal Land Development Authority [1991] 2 MLJ 198; [1991] 3 CLJ (Rep) 27, HC (distd)

Kerajaan Malaysia v South East Asia Insurance Bhd [2000] 3 MLJ 625; [2000] 3 CLJ 705, FC (folld)

LEC Contractors (M) Sdn Bhd (formerly known as Lotteworld Engineering & Construction Sdn Bhd) v Castle Inn Sdn Bhd & Anor [2000] 3 MLJ 339; [2000] 3 CLJ 473, CA (distd)

Teknik Cekap Sdn Bhd v Public Bank Bhd [1995] 3 MLJ 449; [1995] 4 CLJ 697, CA (folld)

Legislation referred to

Rules of the High Court 1980 O 29 r 3

Mah Weng Kwai (Raymond Mah with him) (Mah Weng Kwai Seow & Megat) for the plaintiff.

K Bhuvaneswari (Adha Selvi & Associates) for the defendant.

Ramly Ali J:

[1] In the present originating summons the plaintiff, inter alia, prays for a declaration that the defendant has no right to claim or to call on a design guarantee in the form of a bank guarantee (Ref: BG(P)99/33) dated 8 July

1999 from Maybank Bhd Kajang Branch.

FACTUAL BACKGROUND

[2] On 19 November 1997, the plaintiff and Jabatan Bekalan Air Selangor (now corporatised and known as the defendant) entered into a construction contract known as 'The Design, Construction and Commissioning of a 1500mm Diameter Mild Steel Pipeline from the Existing Bukit Jelutong Reservoir at Shah Alam, Mukim of Shah Alam, Selangor Darul Ehsan'.

[3] The contract was for a sum of RM56,586,000. The initial completion date of the contract was 22 October 1998 and was subsequently extended to 22 February 1999. The plaintiff completed its works by the extended completion date on 22 February 1999.

[4] Pursuant to cl 2.2.1 of the contract, the plaintiff provided the defendant with a bank guarantee for the design of the works. The bank guarantee was issued by the bank on 8 July 1999. It was to remain in force for five years and six months from the date of the practical completion of the works on 22 February 1999. The bank guarantee expired on 22 August 2004.

[5] On 30 June 2003, the plaintiff received a letter from the bank informing the plaintiff that the defendant had made a call on the bank guarantee. The plaintiff did not have any prior notice of any claim from the defendant on the bank guarantee.

[6] As the defendant had attempted to call on the bank guarantee, the plaintiff applied for an ex parte injunction to restrain the defendant from demanding and accepting any monies pursuant to the bank guarantee pending the hearing of the plaintiff's originating summons for a declaration that the defendant is not entitled to call on the bank guarantee for its failure to comply with the conditions of the bank guarantee. This court granted an ex parte injunction on 3 July 2003 and subsequently an inter parte injunction on 12 March 2004.

[7] The bank guarantee expired on 22 August 2004 pending the hearing of the originating summons by this court as well as the defendant's appeal against the interlocutory injunction in the Court of Appeal (which has been disposed off). The issue that remains to be determined by this court at this hearing of the originating summons is whether the defendant has failed to comply with the terms of the bank guarantee in making its call from the bank. In the event this court finds in favour of the plaintiff, the defendant will have no right to recover the sum of the bank guarantee from the plaintiff.

[8] It is important to note that the defendant did not take any steps to preserve the bank guarantee, ie the subject matter of the suit and appeal by filing, for example, an application or the interim preservation of property under O 29 r 3 of the Rules of the High Court 1980.

THE PLAINTIFF'S CASE

[9] The plaintiff's case may be summarised as follows:

(a) the conditions of the bank guarantee do not require the defendant to prove an actual default by the plaintiff in performance of the contract; however, the condition of the bank guarantee at law require the defendant to state the defect(s) or damage(s) to the works in its demand to the bank for the payment of the bank guarantee;

(b) the defendant had failed to comply with the said conditions of the bank guarantee as it did not state the defect(s) or damage(s) to the works or assert any breach by the plaintiff in its demand to the bank; and

(c) accordingly, the plaintiff contended that the defendant's demand to the bank for the payment on the bank guarantee is invalid and ineffective.

THE DEFENDANT'S CASE

[10] The defendant on the other hand, contended that the bank guarantee is such a performance bond which does not require anything more than a 'demand in writing' to call on the bank guarantee. The defendant further contended that the defendant has made a right claim vide a letter of demand dated 27 June 2003 to the bank and thus was entitled to be paid by the bank.

THE BANK GUARANTEE

[11] Clause 2.2.1 of the contract required the plaintiff to provide the defendant with a bank guarantee for the design of the works 'against any defects or damages which may arise due to any defect, fault or insufficiency in design, materials or workmanship or against any other failure which an experienced contractor may reasonably contemplate but shall not include normal replacement and maintenance'.

[12] Pursuant to cl 2.2.1, the plaintiff submitted the bank guarantee to the defendant. The terms of the bank guarantee are as follows:

BANK GUARANTEE FOR DESIGN GUARANTEE BG(P)99/33

In accordance with the terms and conditions of Contract No. (JBA/SEU213/97) for the Design, Construction and Commissioning of A 1500MM Diameter MILD Steel Pipeline From The Existing Bukit Jelutong Reservoir To The Existing

HICOM Reservoir At Shah Alam Mukim of Shah Alam, Selangor Darul Ehsan (herein referred to as 'the Works'), WE, Maybank Berhad, of Nos 28–30, Jalan Tukang, 43000 Kajang, Selangor Darul Ehsan at the request of the Contractor ie Konajaya Sdn Bhd irrevocably undertake and guarantee to the Government against any defect or damage which may arise due to any defect, fault or insufficiency in the design, material or otherwise of the said Works/portion of the Works which the Contractor is responsible for the design, in the manner hereinafter appearing.

Now the Guarantor hereby agrees with the Government as follow:

1) If any defect or damage shall occur to the Works/portion of the Works or any part thereof as a result of any defect, fault or insufficiency in the design, workmanship, materials or otherwise, on the Government first written demand, we shall pay to the Government the amount specified in such demands notwithstanding any contestation or protest by the Contractor or any other third party and without proof or conditions. Provided always that the total of all demands so made shall not exceed the sum of Ringgit Malaysia Four Million Eight Hundred Ninety Five Thousand One Hundred Sixty Only (RM4,895,160.00) and the total amount recoverable against us under this guarantee shall not exceed the said sum ...

4) The Guarantee shall be irrevocable and shall remain in force until 22.8.2004 being the end of a period of five (5) years six (6) months after the practical completion of the works (ie 22.2.1999). Claims if any, must be received by us within the period of Guarantee.

CATEGORISATION OF PERFORMANCE BONDS

[13] It is not disputed that the bank guarantee is a performance bond. Traditionally, performance bonds have been classified either as: (1) a conditional bond; or (2) an unconditional or on-demand bond. This traditional categorisation was explained by the Federal Court in *China Airlines Ltd (formerly known as Maltran Air Services Corp Sdn Bhd) v Maltran Air Corp Sdn Bhd and another appeal* [1996] 2 MLJ 517 at p 534 per YA Mohamed Dzaiddin Abdullah FCJ:

A bank guarantee is a performance bond. There are two types of performance bond.

The first type is a conditional bond whereby the guarantor becomes liable upon proof of a breach of the terms of the principal contact by the principal and the beneficiary sustaining loss as a result of such breach. The guarantor's liability will therefore arise as a result of the principal's default. The second type is an unconditional or 'on demand' performance bond which is so drafted that the guarantor will become liable merely when demand is made upon him by the beneficiary with no necessity for the beneficiary to prove any default by the principal in performance of the principal contract.

[14] Notwithstanding this traditional categorisation of performance bonds, the Malaysian courts have preferred a straightforward exercise of construction, or interpretation of the bond to discover the intention of the parties. This development, away from the traditional categorisation, was the thesis of Professor Vincent Powell-Smith in his article entitled *Calls on Performance Bonds in Malaysia — The Current Law* [1992] 2 MLJ 1 where he wrote:

> ... There has been considerable confusion as to exactly what those principles are, but the fairly recent decision of the English Court of Appeal in *IE Contractors Ltd v Llyods Bank plc and Rafidain Bank* (1991) 51 Build LR 1 has cleared the air by restating the principles to be applied in the construction of performance bonds. The correct approach, the court said, is not to categorise performance bonds as being 'on demand' or 'unconditional' — as seems to have been the past practice — but simply to treat them as contracts and to interpret them as such.
>
> Performance bonds are after all; merely collateral contracts and they should be treated and construed as contracts. No useful purpose is served by categorising performance bonds in a priori manner, whether as 'on demand', conditional or anything else or confusing them with letters of credit.

[15] The Professor's view has been adopted and applied by the Supreme Court in *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149; [1995] 1 CLJ 283 at p 156 (MLJ); p 290 (CLJ), where Peh Swee Chin SCJ emphasised the importance of a 'straight forward exercise of construction', in the followings passage:

> We endorse fully however the view of an eminent local academic that the said description could have served to cloud the real issue — which is one of contractual interpretation of a performance bond and not of the nature of transaction *Calls on Performance Bonds in Malaysia — The Current Law* by Professor Vincent Powell-Smith [1992] 2 MLJ i.
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> That the real issue of a performance bond is one of contractual interpretation was the unanimous view of these judges in the Court of Appeal in *IE Constractors Ltd v Llyods Bank plc and Rafidain Bank* (1991) 51 Build LR 1; [1990] 2 Llyod's Rep 496. It is not our intention to write an essay on performance bonds, in the instant appeal, except to repeat that it 'involves a straightforward exercise of construction, or interpretation of the bond to discover the intention of the parties' per Sir Deny Buckley in *IE Contractors* at p 503, *ibid*.

INTERPRETATION OF PERFORMANCE BONDS

[16] In the interpretation of performance bonds, the Malaysian courts have generally come to three different constructions based on the varying words used in performance bonds. These three possible construction were first

considered by the English Court of Appeal in *Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor* [1985] 2 Lloyds' Rep 546 at p 550 and have been adopted by the Federal Court in *China Airlines* at pp 534–536 and *Government of Malaysia v South East Asia Insurance Bhd* [2000] 3 MLJ 625; [2000] 3 CLJ 705 at p 632 (MLJ); p 711 (CLJ).

[17] The three possible constructions of a performance bond are summarised by the Federal Court in *South East Asia Insurance* at p 632 (MLJ) and p 711 (CLJ):

> There are three possible meanings which can be given to the (performance bond).
>
> First, no more than a mere written demand is required.
>
> Secondly, the demand must assert a failure to perform the contract.
>
> Thirdly, because of the word 'damages', proof thereof and not mere assertion is required before liability under the bond arises.

[18] The court shall now consider the relevant words and phrases commonly used in interpreting performance bonds or bank guarantees.

'PROOF AND NOT MERE ASSERTION'

[19] The words of some performance bonds may make the bond conditional upon proof or inquiry of the breach of the terms of the contract by the principal. The Supreme Court in *Esso Petroleum* at p 157 (MLJ); p 290 (CLJ) held that such conditions may include:

(a) the production of a document, eg a certificate from some nominated independent person like an architect;

or

(b) an inquiry by the guarantor into the existence or otherwise of any breach of the contractual obligation between the principal and the beneficiary.

[20] In the present case this court agrees that the words of the said bank guarantee do not make it conditional upon proof or inquiry of a breach of the contract by the plaintiff.

'A MERE WRITTEN DEMAND'

[21] The words of certain performance bonds do not require anything more than a mere written demand to call on the performance bond. The Court of Appeal in *Teknik Cekap Sdn Bhd v Public Bank Bhd* [1995] 3 MLJ

449; [1995] 4 CLJ 697 at p 455 (MLJ) and p 702 (CLJ) affirmed by the Federal Court in [1998] 3 MLJ xxv cited two such examples:

> There is no doubt that some performance bonds must be paid merely on a demand being made, and whether this is so must depend on the wordings of the bond itself
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> In *Kiremas Sdn Bhd v Federal Land Development Authority* [1991] 2 MLJ 198 the guarantee provides that the guarantor shall 'irrevocably and absolutely guarantee payment on demand without having to assign any reason whatsoever for such demand'. In the light of these clear and unambiguous wordings it can be said that this is an unconditional and a pure 'on demand' bond. What is required to trigger payment in such bonds is the demand simpliciter.
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> In *Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd* [1995] 1 MLJ 149 the then Supreme Court on examination of the performance bond in that case held that it was a pure on demand guarantee and therefore a mere demand would trigger off the guarantees without asserting any reasons thereto. In that case the guarantor 'unconditionally and irrevocably guaranteed payment ...'

[22] In the present case the defendant submitted that the bank guarantee is such a performance bond which does not require anything more than a 'demand in writing' to call on the bank guarantee. The plaintiff, however, submitted that the words of the said bank guarantee make it clear that the defendant must in its written demand state the basis upon which the demand is made ie the demand must assert the failure on part of this contractor.

'DEMAND MUST ASSERT FAILURE'

[23] In *Esal Commodities*, the English Court of Appeal at p 550 adopted this interpretation of the performance bond and held:

> ... in addition to the beneficiary making the demand, he must also inform the bank that he does so on the basis provided for in the performance bond itself. This interpretation not only gives meaning and effect to the words 'in the event that the supplier fails...' which otherwise would be mere surplusage, but it in no way imposes an extravagant demand upon the bank.

[24] In the present case, para 1 of the bank guarantee begins with the words:

> If any defect or damage shall occur to the works/portion of the works or any part thereof as a result of any defect, fault or insufficiency in the design, workmanship, materials or otherwise, on the Government first written demand, we shall pay ...

[25] In this case the court agrees with the plaintiff that the words of the bank guarantee requires the defendant in its written demand to inform the

Bank that its demand is on the basis provided for in the bank guarantee itself. This straightforward interpretation gives meaning and effect to the words 'if any defect or damage shall occur to the works ...' which would otherwise be mere surplusage. In addition, this interpretation in no way imposes any extravagant demand upon the bank, which is not required to inquire or make any evaluation on the merits of the demand. It is also not an unreasonable condition to impose on the defendant, as all that is required is the defendant's bare statement without proof of the basis for its demand on the bank guarantee.

[26] This interpretation is consistent with the words in the preamble of the bank guarantee which states '... WE, Maybank Berhad,... irrevocably undertake and guarantee to the Government against any defect or damage ...' This interpretation is also consistent with the words in Clause 2.2.1 of the Contract which states. '.... It is also agreed that the Contractor ... shall provide a financial guarantee ... against any defects of damages ...'.

[27] Further, this interpretation is consistent with the actions of the bank in informing the plaintiff of the defendant's claim on the bank guarantee and requesting for the plaintiff's objection within three days. The Supreme Court in *Esso Petroleum* held that the purpose of interpreting the performance bond was to 'discover the intention of the parties'. Thus, the bank's intention and understanding of the bank guarantee is very relevant to its proper interpretation. The bank, as the guarantor and party to the bank guarantee, clearly understood the conditions of the bank guarantee as requiring the demand to assert the defect or damages alleged. In the absence of such an assertion by the defendant, the bank found it necessary to inquire with the plaintiff on whether it had any objections to the defendant's demand.

[28] The above was the straightforward interpretation of the English Court of Appeal in *Esal Commodities*. In that case the Court of Appeal at p 550 also held that this interpretation is fair and commercially preferable because:

> A beneficiary may seek, honestly or dishonestly, to apply a performance bond to the wrong contract, and the need to inform the bank of the true basis upon which he is making his demand may be very salutary ... The requirement that he must, when making his demand for payment in order to support his request for an extension, also commit himself to claiming that the contract has not been complied with, may prevent some of the many abuses of the performance bond procedure that undoubtedly occur.

[29] The sensibility of this interpretation was also highlighted by our Court of Appeal in *Teknik Cekap* at p 456 (MLJ); p 703 (CLJ):

> The line of authorities seems to indicate that the courts adopted a strict interpretation of performance bond and that in making demands on them the beneficiary must adhere strictly to their terms. This line of interpretation seems ot be more sensible as it requires the beneficiary of the performance bond to state in plain terms that which they must, if honest, be prepared to assert, and may place him in peril of a charge of obtaining money by deception if later it turns out to be untrue to his knowledge ... The banks are in fact not required to be told the nature of the breach or who is to be blamed for the breach. That is not the concern of the bank but it must be asserted that the demand is made as a result of a breach by the subcontractor.

[30] This court is of the view that it is similarly salutary and desirable for the defendant to commit itself to claiming some 'defect or damage' in the works to prevent any possible abuse of the bank guarantee. The plaintiff is also entitled as a matter of natural justice to know the reason why the defendant is calling on the bank guarantee.

'WITHOUT PROOF OR CONDITIONS'

[31] The words 'without proof or conditions' in the bank guarantee do not mean 'without having to assign any reason whatsoever' as was the case in *Kirames Sdn Bhd v Federal Land Development Authority* [1991] 2 MLJ 198; [1991] 3 CLJ (Rep) 27 (HC). The words 'without proof or conditions' simply mean that the defendant is not required to prove an actual default by the plaintiff in the performance of the contract. This was the first possible construction of performance bonds as explained in *Esal Commodities*. Even if the proof of an actual default is not required, the court maintains that the defendant must state in its written demand the basis upon which the demand is made (which is the second possible construction of performance bonds as explained in *Esal Commodities*).

[32] The court further maintains the words 'without proof or conditions' mean that upon receipt of a valid demand, the bank ought to pay the defendant the sum of the bank guarantee without imposing any conditions. The demand must be valid in the first place. In this case, however, the defendant's written demand was invalid for failing to state the basis for its demand.

'NOTWITHSTANDING ANY CONTESTATION OR PROTEST'

[33] The words 'notwithstanding any contestation or protest by the contractor' are consistent with the above interpretation of the bank guarantee. Similar words 'notwithstanding any contestation or protest' were used in the performance bond in *Teknik Cekap Sdn Bhd v Public Bank Bhd*

[1995] 3 MLJ 449; [1995] 4 CLJ 697 at p 459 (MLJ); p 701 (CLJ) and the Court of Appeal in that case nevertheless held that the bond required the beneficiary to inform the bank of the basis of the demand. This interpretation was affirmed by the Federal Court on Appeal in [1998] 3 MLJ xxv.

[34] The words 'notwithstanding any contestation or protest by the contractor' were also used in the performance bond in *Cygal Bhd v Bandar Subang Sdn Bhd* [2004] 3 CLJ 67 (CA); [1998] 1 LNS 414 (unreported) (HC). In these cases, the High Court held and the Court of Appeal affirmed that 'the defendant in making a claim on the bond merely has to state in the notice to the bank that the plaintiff has breached the contract and the claim has to be made good or honoured'.

THE DEFENDANT'S DEMAND INVALID

[35] In our case, the defendant's written demand dated 27 June 2003 was worded as follows:

> RE: DEMAND ON bank guarantee FOR DESIGN GUARANTEE NO BG(P) 99/93 FOR THE SUM OF RM4,895,160.00
>
> We refer to the above matter and to the bank guarantee for Design Guarantee No BG(P)99/33 dated 8th July 1999 (hereinafter referred herewith as the said bank guarantee). Please find enclosed herewith a copy of the said bank guarantee for your perusal.
>
> WE PERBADANAN URUS AIR SELANGOR BERHAD (572635-A) (formerly known as 'Jabatan Bekalan Air Selangor' which was corporatised on 15 March 2002) or PUAS BHD in short, having our business address at IBU PEJABATPERBADANAN URUS AIR SELANGOR BERHAD, JALAN PANTAI BAHARU, 59990 KUALA LUMPUR hereby demand form your goodselves under the above bank guarantee a sum of RM4,895,160.00 (Ringgit Malaysia Four Million Eight Hundred Ninety Five thousand One Hundred Sixty only) (hereinafter referred to as the said sum) notwithstanding any contestation or protest by the contractor or any other third party and without proof or conditions. (Emphasis added).
>
> Please remit all payment of the said sum by cheque or bank draft made payable to PERBADANAN URUS AIR SELANGOR BERHAD within twenty one (21) days from the date hereof.

[36] It is evident from the defendant's written demand that the defendant had failed and omitted to state any 'damage or defect' to the works or any breach of the plaintiff's obligation under the contract. This omission is fatal and renders the defendant's written demand invalid and ineffective because it does not comply with the condition of the bank guarantee as interpreted by the Federal Court. Accordingly, the defendant is not entitled to any payment

A under the bank guarantee.

EVALUATION OF THE AUTHORITIES

Esal (Commodities) Ltd & Anor v Oriental Credit Ltd & Anor [1985] 2 Lloyds'
B Rep 546 (English CA)

[37] The performance bond in *Esal Commodities* at p 548 states:

> *we undertake to pay the said amount on your written demand in the event*
C *that the supplier fails to execute the contract in perfect performance ...*

In interpreting the words of the bond, the English Court of Appeal held at p 550 that:

> *... in addition to the beneficiary making the demand he must also inform*
D *the bank that he did so on the basis provided for in the performance bond.*

Teknik Cekap Sdn Bhd v Public Bank Bhd [1995] 3 MLJ 449; [1995] 4 CLJ 697 (CA)

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[38] The Court of Appeal there found that when making the demand the beneficiary did not assert that there was a failure to perform the contract. The court then came to the conclusion the condition had not been complied with.

F **[39]** The facts of the present appeal are on all fours with the case of *Teknik Cekap*. In that case, the bond began with the words at p 702:

> *If the subcontractor shall in any respect fail to execute the contract or commit any breach of his obligations under there then the guarantor shall*
G *pay ...*

[40] The Court of Appeal held that the very wordings of the bond itself is clear and unequivocal that in addition to the beneficiary making the demand he must also inform the bank that he did so on the bases provided for in the
H performance bond. However, the letter of demand in *Teknik Cekap* merely states at p 703:

> *We ... hereby give you notice that we wish to make a claim for the full amount against the above said performance bond.*

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[41] Accordingly, the Court of Appeal held at p 457 (MLJ) and p 703 (CLJ) that the demand was invalid and that any payment pursuant thereto was also invalid and ought to be returned. The court states:

> Nothing in the demand is mentioned either expressly or at least in

substance that the contractor had failed to perform the subcontract or that it had committed a breach thereof. Having given this matter my serious consideration and applying the proposition in *Esal*'s case which proposition I agree and accept, I hold that the appellant had failed to assert the very basis of the demand as required by the bond and, therefore, the letter of demand made pursuant to the performance bond in this case is invalid and consequently any payment made thereunder by PBB is also invalid and ought to be returned.

[42] Here, in the present case the bank guarantee which begins with 'If ...' is practically identical to the words of the bond in *Teknik Cekap*. This court is of the view that the court ought to follow the strong persuasive authority in *Teknik Cekap* which was affirmed by the Federal Court on appeal.

China Airlines Ltd v Maltran Air Corp Sdn Bhd and another appeal [1996] 2 MLJ 517; [1996] 3 CLJ 163 (FC)

[43] In *China Airlines*, the letter of guarantee provided at p 533 (MLJ) reads as follow:

The said sum shall become payable by us in the event of the said Messrs Maltran Air Corporation Sdn Bhd's failure to perform the said covenants.

In interpreting the letter of guarantee, the Federal Court applied the principles in *Esal Commodities* and agreed that the beneficiary making the demand has to inform the bank of his basis for doing so. However, in *China Airlines*, the Federal Court held at pp 537–537 that the demand was valid because the qualifying words in the letter of guarantee had been compiled with:

Here, to comply with the terms of the said guarantee, the solicitors' letter to the bank dated 14 November 1989 specifically demanded payment of RM400,000 under the said guarantee giving the reason that the agent held failed to perform its part of the covenants under the GSA agreement. In addition to making this demand, the letter asserted that it was so made because under Article VII of the agreement, the agent had the unconditional responsibility for the due payment to the airline of monies in respect of tickets sold which it had continuously failed to settle. The solicitors also enclosed in the demand letter the correspondence exchanged by the parties. In our view, the reference to the breach under Article VII of the GSA agreement in the letter of demand does give meaning and effect to the qualifying words in the guarantee, ie in the event of the agent's failure to perform the covenants in the agreement. Thus, on the above grounds, we are satisfied — as was the qualifying words in the latter part of the guarantee had been fulfilled.

Government of Malaysia v South East Asia Insurance Bhd [2000] 3 MLJ 625; [2000] 3 CLJ 705 (FC)

[44] In *South East Asia Insurance*, the performance guarantee at p 631 (MLJ) and p 711 (CLJ) reads:

A The guarantor shall pay damages to the government a sum not exceeding RM420,645 within three months upon receipt of a written notice demanding that the guarantor pays the government for any breach of the contract's obligations under the contract ...

B In interpreting the words of the performance guarantee, the Federal Court stated that 'the demand must assert a failure to perform the contract'. On the fact of this case, the Federal Court found that the notice of demand was valid because it had a clear assertion of the contractor's breach of the contract. The notice of demand at p 632 (MLJ) and p 712 (CLJ) read:

C I am directed to inform you that the contractor had defaulted in completing the works stated above. Please see our notice of termination to the contractor ref (76) dim. PPS.07/4T/2/50 dated 30.11.1992 which we served on you earlier. Following the above notice of termination, we served on you earlier. Following the above notice of termination, we hereby demand from you payment under the following
D guarantees ...

Cygal Bhd v Bandar Subang Sdn Bhd [2004] 3 CLJ 67

[45] In *Cygal Bhd*, the operative words of the performance bond at p 4 are:
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If the contractor.. shall in any respect fail to execute the contract or commit any breach of his obligation thereunder then the guarantor shall pay ...

In interpreting these operative words, the High Court (per Low Hop Bing J)
F applying *Teknik Cekap* held that 'the defendant in making a claim on the bond merely has to state in the notice to the bank that the plaintiff has breached the contract and the claim has to be made good or honoured'. On appeal, the Court to Appeal affirmed the decision.

G *HSH Engineering & Construction Sdn Bhd v Belton Properties Sdn Bhd* [2001] MLJU 85; [2001] 2 CLJ 186

[46] The High Court in *HSH Engineering* properly applied the principles of interpretation adopted by the Federal Court in *China Airlines* and *South*
H *East Asia Insurance*. In *HSH Engineering*, the performance bond at page reads:

If the contractor ... shall in any respect fail to execute the contract or commit any breach of his obligation thereunder then the guarantor will indemnify ...

I **[47]** This court in that case held p 10 (MLJU); p 192 (CLJ), that the letter of demand 'had fulfilled the necessary requirement and there is a clear assertion that the plaintiff had failed to execute the contract and committed breaches of its obligation under the contract'. The operative words in the letter of demand in that case read as follows:

> The contractor has failed to execute the contract and committed breaches of his obligations under the said contract and the contractor .. and in the circumstances you will indemnify ...

Esso Petroleum Malaysia Inc v Kago Petroleum Sdn Bhd [1995] 1 MLJ 149; [1995] 1 CLJ 283 (SC)

Esso Petroleum case can be distinguished from the present case because the words of the bank guarantee in that case do not require the demand to state the grounds or basis for such a demand. The bank guarantee at p 153 (MLJ) and p 287 (CLJ) reads:

> In consideration of *Esso Production Malaysia Inc*. (EPMI) agreeing to release to Perbadanan Ladang-Ladang Tabung Haji Sdn Bhd (PLLTH) the sum of DM466,562 (Four hundred sixty six five hundred sixty two only) being the amount of liquidated damages (L/D) presently withheld by EPMI pursuant to several purchase Orders made between EPMI and PLLTH, we hereby Unconditionally and Irrevocably guarantee the payment to EPMI, the Ringgit equivalent of the sum of DM466.562 (Four hundred sixty six five hundred two only).

[48] The Supreme Court described this bank guarantee as a 'pure on-demand guarantee' not requiring any declaration or documentation by the beneficiary or inquiry by the bank into any breach between the parties.

LEC Contractors (M) Sdn Bhd (formerly known as Lotteworld Engineering & Construction Sdn Bhd) v Castle Inn Sdn Bhd & Anor [2000] 3 MLJ 339; [2000] 3 CLJ 473 (CA)

LEC Contractors case can also be distinguished from the facts of the present case. In *LEC Contractors*, the words of the bank guarantee at p 358 (MLJ) and p 482 (CLJ) reads:

> If the contractor ... shall in any respect fail to execute the contract or commit any breach or his obligation thereunder then the guarantor shall pay ...

[49] The demand by the beneficiary was made on its behalf by its solicitors and at p 349 (MLJ) and p 484 (CLJ) reads:

> We are instructed to inform you that Lotteworld Engineering & Construction Sdn Bhd is in breach of its obligation under the contract, inter alia, for falling to comply with the Architect's Notice of Default dated 26th June 1998 resulting in our client determining Lotteworld Engineering & Construction Sdn Bhd's employment under the contract. Please find enclosed the relevant letters.

A We hereby demand that the sum of RM4,800,000 under the performance bond be paid forthwith to our client or to us as its solicitors.

[50] Although the Court of Appeal in *LEC Contractors* briefly cited the principles of interpretation enunciated in *Esal Commodities*, the Court of Appeal in *LEC Contractors* did not consider the issue of whether it was a condition of the bank guarantee that the demand expressly states the basis on which the demand was made. Further, the Court of appeal in *LEC Contactors* did not consider that the principles of interpretation in *Esal Commodities* were applied and adopted by the Federal Court in *China Airlines* or *South East Asia Insurance.*

[51] Instead of interpreting the words of the performance bond, the Court of Appeal in *LEC Contactors* focused on the traditional classification of whether the performance bond was a conditional or unconditional bond.

[52] Notwithstanding, the decision in *LEC Contractors* is consistent with the cases of *Esal Commodities*, *China Airlines* and *South East Asia Insurance*. As can be seen from the extract of the demand above, the demand clearly stated the basis for calling on the bond, that is, because the plaintiff had breached the contract by failing to comply with the architect's notice of default.

THE DEFENDANT'S LACK OF GOOD FAITH

[53] The court also finds that the defendant's action show a lack of good faith because the defendant had applied to call for the bank guarantee and to receive the RM4,895,160 without any notice to the plaintiff; and without giving any reason or complaining of any defect of damage to the works or any breach of the contract.

[54] The court is of the view that it is a matter of natural justice that the plaintiff be informed by the defendants of its demand on the RM4,895,160 and what exactly the plaintiff is allegedly in breach of. This is especially so when the conditions of the bank guarantee according to the Federal Court in *China Airlines* and *South East Asia Insurance* expressly require the defendant to do so.

CONCLUSION

[55] Based on the above considerations, the court finds that the defendant's letter of demand dated 27 June 2003, calling for the bank guarantee, failed to comply with the conditions set out in the bank guarantee, and thus the

defendant is not entitled to call on the said bank guarantee. Therefore, the plaintiff's originating summons is allowed with costs. A

Plaintiff's application allowed with costs.

Reported by Andrew Christopher Simon B

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